

## **BOOK REVIEWS**

Edited by N. Stephan Kinsella\*

**HERNANDO DE SOTO. *THE MYSTERY OF CAPITAL: WHY CAPITALISM TRIUMPHS IN THE WEST AND FAILS EVERYWHERE ELSE*. NEW YORK: BASIC BOOKS, 2000. PP. 276.**

Why capitalism triumphs in the West and fails everywhere else is the question that Hernando de Soto, the acclaimed author of *The Other Path*,<sup>1</sup> tries to answer in *The Mystery of Capital*. To be sure, the question is not new; the world's libraries are filled with books which claim to answer it. Indeed, there is a glut of books claiming that the continued existence of poverty ("underdevelopment" is the technical, fashionable word in the economics jargon) is the result of such factors as culture, religion, geography, meteorology, human greed, and lack of entrepreneurship.

However, books claiming that the problem is the lack of respect for private property rights are as scarce as a cup of water in the desert. De Soto's new work should attract the attention of every libertarian reader because it is one such cup of water. However, as I will explain, drinking from de Soto's cup is not always refreshing.

The author points out that capitalism has failed in the third world and former communist countries because of the lack of easy access to formal property. In fact, a huge part of their populations deal with so many legal barriers to formal recognition of their property (the scarce resources over which they have control) that their alternatives

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\*General Counsel and Vice President for Intellectual Property at Applied Optoelectronics, Inc. To submit reviews for this section, visit him online at [www.stephankinsella.com](http://www.stephankinsella.com).

<sup>1</sup>Hernando de Soto, *The Other Path: The Invisible Revolution in the Third World* (New York: Harper & Row, 1989).

are either resignation or entry into the informal extralegal sector (the black market). In de Soto's book, the black market is a promising fountainhead of solutions (p. 88), rather than a source of guilt for the problems of poverty.

As examples of these legal barriers, it took de Soto's team in Peru six years and eleven months, and 207 administrative steps in fifty-two different governmental offices, to obtain legal authorization to build a house on state-owned land. Obtaining the legal authorization of ownership required 728 steps. Similarly, it took 289 six-hour days of work by his team, as well as \$1231 in prepayment fees, to legally open a small garment workshop in the same country, an objective that was accomplished in a single morning in the United States. Moreover, taking into account the fact that \$1231 for a Peruvian represents approximately thirty-one times the monthly minimum wage, one can understand why so many people prefer the black market. De Soto's team conducted similar investigations in the Philippines, Egypt, Haiti, and other Third World countries with the same kind of striking and discouraging results.<sup>2</sup>

Given these barriers to formal property, the creation of capital in these countries is nearly impossible. And the solution is not "that leaders of the Third World and former communist nations wander the world's foreign ministries and international financial institutions seeking their fortunes" (p. 37), but to make formal property universally accessible (p. 218).

This is so, de Soto claims, because the poor in these countries already own an incredible amount of land, houses, and businesses. They own capital, but of a special kind: "dead capital," capital that is not officially recognized.

By the calculations of the author's team, "the total value of the real estate held but not legally owned by the poor of the third world and former communist nations is at least \$9.3 trillion" (p. 35). By comparison, the foreign aid or assistance from developed state governments to their Third World colleagues is relatively insignificant. Likewise, the value of this real estate is more than twenty times the

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<sup>2</sup>A similar analysis of the U.S., Hong Kong, and India can be found in John Stossel, *Is America Number One?*, ABC News Home Video, 1999, videocassette. Stossel found that he could go into business in Hong Kong in one day, and in New York City in a few weeks, but in India it would take several months at least, and possibly several years.

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total direct foreign investment made during the 1990s into all Third World and former communist countries.

But how could the simple formal recognition of property be the solution for the development of Third World and former communist nations? Continuing along the same line, de Soto argues that easy and universal access to formal property would allow people to generate productive capital. Formal property enables people to think about assets not only as physical materials, but also as “the description of their latent economic and social qualities” (p. 51). It integrates dispersed information into one standardized and integrated legal representational system, thereby making people accountable, since it shifts “the legitimacy of the rights of owners from the politicized context of local communities to the impersonal context of law” (p. 54).

The standardization that brings about formal property also serves to make assets fungible, thereby reducing transaction costs involved in mobilizing and utilizing assets. Moreover, these effects convert people into “a network of individually identifiable and accountable business agents” through which they can conjoin their assets into more valuable combinations (p. 61). Finally, this network created by a formal property system constitutes a protection of property records (titles and contracts) every time they are involved in transactions in time and space.

Reduced to its bare essentials, de Soto’s argument is that an easy, universal, and integrated system of formal property enables people to use their assets to produce and accumulate capital. Hence, the argument runs, formal property is the key to the division of labor and increase of productivity; thus, it is the key to the success of capitalism in the Third World and former communist nations. Likewise, in the international arena, it is the tool with which to take advantage of the globalization process.

In order to illustrate his argument, de Soto turns to the American experience. He shows that the problems now facing Third World and former communist countries are not new. Not so long ago, the citizens of North America had to struggle against their governments and their privileged elites in order to receive recognition of their property over the resources they already controlled. Only then did the U.S. begin the process of capitalization that made this country what it is today: a rich, capitalized country.

There may be nothing logically wrong with this explanatory chain, so far as it goes. Unfortunately, as soon as you go beyond the main

arguments, the structure of his hypothesis loses balance, and the entire edifice loses its value as a coherent defense of property rights and capitalism as the salvation for developing countries.

While *The Mystery of Capital* is full of statements concerning the need for the formalization of private property, nowhere does it offer a definition of “private property.” Likewise, the book makes no effort to define what kinds of goods can be the object of a rightful appropriation, much less when such rightful appropriation can occur.

How, then, does the author articulate property rights? And why should they be defended? De Soto’s defense of property rights is not grounded on justice, nor is it a pure, logical defense. Rather, de Soto takes an extremely narrow utilitarian approach based on efficiency and rooted in social contract. He argues that property derives its legitimacy from “social contracts that determine the existing property rights” (p. 172).

De Soto even appeals to Kant against Locke when he writes that “all property rights spring from social recognition of a claim’s legitimacy” (p. 171). But if a “social contract has to precede real ownership” (p. 171), how is it possible to have a valid social contract where the contracting parts do not own themselves? To be sure, if individuals can make a contract, it is because they own themselves, and if they have to own themselves to make a contract, it follows that property has to precede contracts. If it does not, only violence, and not peaceful contract, is possible.

In this context, why does de Soto believe that formal property must be universally accessible? To this question he has a clear answer: “to bring everyone into one social contract where they can cooperate to raise society’s productivity” (p. 218). However, this answer’s utilitarianism does not allow it to escape the trap of circular reasoning. As far as I can understand this argument, property, and, therefore, formal property, requires a previous social contract, and, once it is legitimate, universal access to it must be defended because it unites everyone into one social contract. It may be that these two social contracts are totally different, but, if so, he should start the explanation from the beginning.

Once this problem is seen clearly, the reader is not astonished that de Soto finishes the book by saying,

I am not a die-hard capitalist. I do not view capitalism as a credo. Much more important to me are freedom, compassion for the poor, respect for the social contract, and equal

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opportunity. But for the moment, to achieve those goals, capitalism is the only game in town. It is the only system we know that provides us with the tools required to create massive surplus value. (p. 228)

Another interesting question is who should be in charge of recognizing ownership, since this is the way that de Soto plans to solve the whole problem. For the author, the answer is clear: the State, through its group of managers (the government), is the ideal agent to remedy the chaos created through its previous policies. In fact, de Soto's vision of government is not one that passively allows people to arrange their own lives; rather, he desires a government that actively moves people in the right direction (possibly through the government's contracting with a private company that will search for the needed information). Thus, de Soto reasons that

[c]itizens inside and outside the bell jar need government to make a strong case that a redesigned, integrated property system is less costly, more efficient, and better for the nation than existing anarchical arrangements. (p. 159)

In the same vein, de Soto reminds governments that “without the tools of formal property, it is hard to see how . . . tax collection [could] work” (p. 60). Later, he states that

Formalization will provide government . . . with . . . taxes . . . . In addition, a formal property system supplies a database for investment decisions in health care, education, tax assessment, and environmental planning. (p. 195)

In view of all this, it should not amaze anybody that the author dedicates six pages to the bright side of Marx (pp. 212–18). While de Soto is clearly not a Marxist, his “facing up to Marx's ghost” turns out to be a cheerful reading of several Marxist concepts, especially his class theory. For example, de Soto writes that when people are extremely dissatisfied, “the Marxist tool kit is better geared to explain class conflict than capitalist thinking, which has no comparable analysis or even a serious strategy for reaching the poor in the extralegal sector” (p. 213). Marx divides social classes according to ownership of the means of production, and de Soto adapts this theory to his main claim, i.e., that classes exist because some people have access to formal property, while others do not; the latter, then, are condemned to poverty (p. 213).

Although this view is popular and prevalent, it is incorrect. One can hardly contend that Marxist class theory is richer in explanatory

power than, e.g., Oppenheimer's.<sup>3</sup> It makes far more sense to point out that some individuals—especially those in government—impose access restrictions on others. By specifying who can use force to constrain access to non-owned scarce resources, the government creates the very classes that de Soto and Marx claim are products of the economic system. Once we recognize this, we can apply it to formal property by making the distinction between individuals who use political power—who use violence or the threat of it to prevent others from gaining access to the full exercise of their property rights—and individuals who do not use means that violate the property of others, or prevent them from formalizing it.

As long as someone can legally use force or political power for aggression against another's property, it is possible to differentiate between two distinct classes. And, by the way, this is a perfectly capitalist analysis of the problem. Unfortunately, de Soto is inconsistent on this issue. He sometimes disregards the use of violence against non-aggressors, and relies on the ownership of factors of production as his yardstick of a class theory; at other times, he correctly points out how official documents have been used for outright domination. If de Soto consistently and explicitly applied the latter distinction, he would not be stuck trying to restore Marxist class theory to explain visible class distinctions.

Once this analytical tool is adopted, it becomes puzzling how an institution whose main feature consists in being the legal monopoly of the use of violence against aggressors and non-aggressors, as well as being the ultimate judge of all disputes, can be the guarantor of formal recognition of property. Instead of recognizing this problem and calling for a halt to government aggression in this field, de Soto relies on a change in the way politicians use political means and legal violence (p. 205). His proposed solution seems to rely on a state takeover of the competing extralegal organizations that currently administer formal property access.

Other obscure points of this book are his out-of-place, or at least disproportionate, attack on lawyers as the most probable saboteurs of the necessary reforms (pp.197–201), his incorrect use of the term “anarchism” (pp. 30, 159, 175), and his poor and unconvincing defense of patents and copyrights (pp. 70, 83–84, 198, and 224).

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<sup>3</sup>See Franz Oppenheimer, *The State: Its History and Development Viewed Sociologically*, trans. John M. Gitterman (New York: B.W. Huebsch, 1922).

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Finally, the book seems to follow from a good intuition—that you cannot have development without respect for property, and that you cannot understand poverty or underdevelopment while disregarding the formal situation of property rights. But in the book itself, this argument goes only so far. You cannot hold that, once you create a framework where formal property is easily accessible for everyone, development will be attained. It is true that, once you have a society where legitimately acquired property is respected, development would obtain or, at least, the best possible condition for development would exist.

This environment can be reached by a voluntary restraint on aggression against other people's property, or by using force to defend legitimately acquired property. In the case where others do not engage in voluntary restraint, we will need to defend property against aggressors. Such a defense can be undertaken directly by the property owner, or by contracting for it with a third party or agency. In this context, formal property is just one factor that can be helpful in the defense of property rights.

We still have to look at what kind of institution or agency would certify this formal property, and, what is even more important, at the very definition of property rights that the agency would use. During the National Socialist period in Germany, formal property was respected more fully than in many developed countries, but this did not prevent property from being practically and legally managed from the Reichstag. Given enough time, the productivity and capital structure in Germany would have collapsed in a way similar to its subsequent collapse in socialist countries.

Ultimately, and contrary to de Soto, while the formalization of property rights might be of great importance for their respect and, hence, for the development of a society, it is neither a sufficient nor a necessary condition.

GABRIEL CALZADA ÁLVAREZ  
*Universidad Complutense  
de Madrid*